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## First Discussant Comment on “The Future of U.S. Housing Finance Reform”

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The plan laid out in this very thoughtful and readable paper envisions a transition in the secondary mortgage market away from dependence on government guarantees and toward primary reliance on private capital. Although the plan is broadly similar to several other proposals put forward, the various proposals differ in important respects, such as how to structure and price any remaining federal credit guarantees, how to structure and regulate the secondary market, and whether and how to support affordable housing.<sup>1</sup> This plan, which builds on the author's earlier work with Donald Marron, takes a pragmatic approach to reducing reliance on government guarantees while recognizing the difficulties of credibly eliminating all government support from the secondary mortgage market.

Specifically, the paper begins by enumerating a set of goals for the reform and goes on to describe a plan for achieving them. Those goals include supporting home ownership, protecting taxpayers, protecting the financial system and the economy against systemic risk, clarifying the roles of the private and public sector, fostering competition and innovation, providing continued public support for affordable housing, and arriving at a housing system that will be stable over time. The key elements of the proposed reform are a secondary government backstop on conforming MBSs, entry and competition in the securitization of conforming MBSs, a gradual increase over time in the price of government insurance and a decrease in its coverage, the use of part of the insurance premiums to fund affordable housing activities, and the sale of Fannie and Freddie to the private sector.

An important theme running through the paper is that even though a consensus has not yet been reached on the ultimate role of the government in the secondary mortgage market, the first steps toward a smaller government presence will be the same no matter what end point is eventually decided on, and that starting to move down that path sooner rather than later is both feasible and desirable. In this discussion I will elaborate on some of the important elements of the proposal, explain why changes to budgetary accounting for mortgage guarantees should be part of the reform, and also comment on some aspects of the proposal that seem problematic.

### **Pricing of Government Guarantees**

Many of the problems inherent in the pre-crisis system arguably have their roots in the underpricing of government guarantees. In particular, the implicit federal guarantee of the obligations of Fannie Mae and Freddie Mac (and other preferences granted in their charters) gave them a significant advantage over potential competitors. Those advantages allowed those government-sponsored enterprises (GSEs) to dominate the segments of the secondary mortgage market in which they

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<sup>1</sup> See Congressional Budget Office (CBO) 2010 for an overview of those proposals and a more detailed discussion of alternative approaches and the tradeoffs between them

were allowed to operate; in turn, their size and dominance made them a significant source of systemic risk for the financial market and broader economy.

The chronic underpricing of government guarantees and the distortions thereby created is one of the strongest arguments for bringing private risk capital back into the secondary mortgage market. A critical element of the author's plan involves increasing the price of government guarantees gradually over time, and starting that process immediately. Increasing guarantee fees is a prerequisite for reviving the private securitization market sooner rather than later. It is also important for increasing the transparency of the remaining housing subsidies and discouraging excessive risk-taking by borrowers, lenders, and the government: and for increasing the transparency of remaining housing subsidies. Of course more accurate pricing would not eliminate the risk of future bailouts, but it could lower their probability and reduce distortions in the allocation of capital between housing and other productive uses.

In recent years over 85 percent of new mortgage originations have been federally backed, either by Fannie and Freddie, or by fully federal agencies such as the Federal Housing Administration (FHA). To make it possible for private entities to compete in the conforming market will require some combination of increases in GSE guarantee fees and reductions in loan size limits on conforming mortgages.<sup>2,3</sup> Although there is considerable uncertainty about how much guarantee fees would need to be increased to attract private capital to the market, an advantage to initiating a gradual fee increase is that it would reveal the private supply curve. A gradual increase also would allow policymakers to limit the impact of higher fees on the still-weak housing market. Lowering the conforming limit, which could be done together with a fee increase or as a stand-alone policy, would also force more borrowers to rely on private capital. However, the limits would have to be reduced dramatically before a sizeable fraction of mortgages would become ineligible for GSE purchase.<sup>4</sup> Furthermore, decreasing the conforming limit without simultaneously increasing guarantee fees could result in significant price discrepancies above and below the conforming limit, which could erode support for the reform.

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<sup>2</sup> To get market signals about prices the proposal includes the start up of an auction process for federal backstop guarantees while Fannie and Freddie are still federal entities and the main channel of funding for conforming mortgages. How the cost of those purchases would be paid for seems tricky, and it would be worthwhile for the author to more fully explain how that transition would work under this plan.

<sup>3</sup> Some commentators also have emphasized regulatory and legal uncertainties as impediments to a re-emergence of private sector securitization. However, the below-market pricing of government guarantees would crowd out private participation even if the other impediments currently limiting entry by competitors were addressed.

<sup>4</sup> Currently the loan limit in most areas is \$417,000 but the median residential mortgage is about \$170,000.

The author emphasizes both the difficulty of preventing the government from underpricing its guarantees, and that bringing in private capital is the best way to make sure that taxpayers are compensated for bearing risk and are protected from risk. He also observes that assessing some fee for a backstop guarantee would be better than giving it away for free. I agree on all counts. However, the proposal neglects to mention an important impediment to any effort to address underpricing: the current budgetary treatment of federal credit programs. Budgetary estimates are generally taken to be the best available cost measures in policy discussions. For most credit programs, however, budgetary estimates of cost are systematically lower than market values because there is no charge included for the risk transferred to taxpayers. If the government were to adopt a market (or fair) value approach to calculating the cost of its credit obligations, the cost of the risk transferred to taxpayers would be more apparent to policymakers and the public, perhaps making it more palatable to charge higher fees.<sup>5</sup> The current budgetary accounting for Fannie Mae and Freddie Mac is particularly problematic. Although the GSEs are in federal conservatorship and controlled by the government, they are accounted for by the executive branch as if they were nongovernmental; the President's budget only shows a cost when the Treasury infuses the GSEs with cash. Under that accounting rule, if the GSEs were to increase their fees to the point where private financial institutions would find it attractive to enter the conforming mortgage market, Fannie and Freddie would soon look like major profit centers for the government, which could become a further impediment to their privatization.<sup>6</sup>

### **Housing Subsidies**

The proposal calls for continued federal support for affordable housing through the FHA or some other fully federal agency. Existing mandates on the GSEs to support affordable housing—which a number of studies have found to be fairly ineffective and poorly targeted—would be eliminated. Instead, subsidies for affordable housing would be funded with the guarantee fees collected on the backstop insurance sold by the government to private securitizers of conforming mortgages. (The proposal does not elaborate on the design of future affordable housing programs.)

Replacing mandates on the GSEs and other financial institutions with subsidies funded through the budget process would be a significant step towards

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<sup>5</sup> As described in CBO (2010), most federal credit programs are accounted for under the Federal Credit Reform Act of 1990, which proscribes the use of Treasury rates for calculating the net present value of the expected cash flows associated with a direct loan or loan guarantee. By contrast, fair value estimates reflect that investors discount expected loan cash flows at interest rates that are higher than Treasury rates.

<sup>6</sup> The CBO accounts for the GSEs differently than does the executive branch. It uses a fair value basis of accounting, which has the effect of aligning budget costs with economic costs. On a fair value basis, for example, sales of MBSs at market prices are budget neutral.

increasing the transparency of housing subsidies and legislative control over them. However, the specific suggestion of funding housing subsidies with income from the guarantee fees is essentially a budget gimmick that would tend to obscure the economics of the situation. After all, if the backstop guarantees were fairly priced then the income generated would just cover the cost of the guarantees; no surplus would be created from which to fund other government activities. In the more likely case that the guarantees would be underpriced, they would represent a cost to the government, not a source of available revenue.<sup>7</sup>

A further caution is that moving affordable housing subsidies onto the budget without modifying the way they are accounted for would not make the subsidies transparent, and it could slow the transition to a less government-dominated market. As the paper notes, an undesirable feature of the pre-crisis system was that the government provided implicit guarantees at no cost to the GSEs. A perverse feature of the current system is that the FHA provides explicit mortgage guarantees at below-market prices and shows budgetary profits from doing so because of the way guarantees are accounted for. The FHA currently guarantees more than 17 percent of residential mortgage originations. It provides guarantees to borrowers who tend to be less creditworthy than conforming borrowers, and FHA-insured mortgages have loan-to-value ratios as high as 97 percent. Despite the risks involved, a history of higher-than-expected loss rates, and below-market pricing, FHA mortgage guarantees reduced the reported budget deficit by about \$4.4 billion in 2012 (CBO 2011). By contrast, the Congressional Budget Office estimates that on a fair value basis those same guarantees would have a subsidy cost of \$3.5 billion. If the GSEs were directed by their regulator to increase their guarantee fees as called for under this plan, and FHA pricing were to remain at current levels, some borrowers who currently opt for a conforming mortgage would switch to the FHA. The favorable budgetary treatment of the FHA is a disincentive for policymakers to limit guarantee volume or to raise fees in that program. Hence making housing subsidies “explicit, on budget, and subject to a vote of Congress” as proposed in the paper is an important goal, but probably insufficient to create transparency without also instituting accounting reforms that recognize the full cost of credit guarantees.

## Market Structure

A critical design issue for proposals such as this one, which combines private and government capital, is the number and types of private intermediaries that would be permitted to purchase the federal guarantees. Proposals range from licensing a small number of highly regulated private entities—often referred to as “the public utility

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<sup>7</sup> More generally, from the perspective of a unified budget it is not meaningful to earmark revenues for specific purposes.

model”—to allowing any private financial institution that met certain regulatory criteria to participate—a “big tent” model.

The author favors the big tent model, which I think has several features that would make it more economically and politically robust than a public utility approach. Importantly, the credit risk of conforming mortgages would be widely spread across diversified institutions, which could reduce systemic risk relative to both the pre-crisis model and the public utility model. A moderately large shock to house prices could create distress for a monoline housing guarantor (or for many smaller monoline guarantors), but it would be less likely to threaten the capital reserves of well-diversified financial institutions. Diversification could thereby prevent moderately large house price shocks from becoming systemic shocks requiring government intervention. Opponents of the big tent model rightly note that opening the federally backstopped securitization market to diversified financial institutions creates the risk that losses from their other activities will impede their ability to participate in the mortgage market, which could pose additional risks to taxpayers. However, such risks could be mitigated by the capital and other eligibility requirements for firms purchasing backstop insurance.

Regulatory capture is another concern that would probably be less of a problem under the big tent model. Under the public utility approach, there is the risk that specialized housing regulators may become more responsive to the goals of the regulated securitization firms or to housing interests than to the interests of the general public. Although large financial institutions and their regulators also are susceptible to political influences, bank regulators probably would be less likely than a specialized entity to favor housing over other interests.

A further advantage of the big tent approach is that it would foster competition in guarantee pricing, which could help ensure that the benefits of federal support would be passed through to mortgage borrowers rather than retained by the stakeholders of financial intermediaries. In addition, a structure that encourages greater integration between the markets for private-label and federally backed MBSs could promote operational efficiencies, foster innovation, and encourage a more rapid re-emergence of the private-label securitization market.

As the author notes, a concern about the big tent model is that it may not create a level playing field for smaller mortgage originators. The costs to securitizers of working with smaller originators probably are higher than for larger entities, which in a competitive market would leave smaller players facing higher prices to securitize their loans. If policymakers want to prevent that outcome, one possibility would be to encourage the Federal Home Loan Banks (which are in many ways are similar to the public utilities envisioned by some proposals) to serve as a low-cost entry point for small originators, as some of those banks have done in a more limited way in the past.



## Supported Mortgage Products

Mortgage products that qualify for federal backing tend to be popular, and hence the government's backstop guarantees could be used to encourage greater reliance on product types that meet the needs of borrowers and that foster a stable mortgage market. Because it is doubtful that the 30-year fixed-rate mortgage is the best contractual arrangement for achieving those goals, I was disappointed that the paper took the continuing availability of 30-year mortgages at a "reasonable" cost to borrowers as a prominent goal of the reform. As the author mentions, a government guarantee is likely to be necessary to ensure the broad availability of 30-year fixed rate mortgages, which remain a popular choice in this country. However, foreign experience suggests that 30-year mortgages would be less attractive to borrowers if they were not as heavily subsidized, and that high rates of homeownership are achievable without heavy reliance on that product.

From a borrower perspective, a 30-year fixed-rate mortgage offers people who plan to stay in their current residence for many years the prospect of predictable payments and the opportunity to refinance if interest rates fall. However, from an investor perspective a 30-year fixed-rate mortgage without prepayment penalties is an exotic derivative security that exposes them to considerable interest rate and prepayment risk. Mistakes in pricing and hedging mortgage risk contributed to the savings and loan crisis of the 1980s and led to the near insolvency of Fannie Mae around the same time. Financial products that are extremely unsafe for investors are generally not a good deal for borrowers. To compensate investors for the risks, 30-year fixed-rate mortgages bear higher interest rates and are more susceptible to disruptions in supply than are mortgages that are easier for investors to evaluate and price. For homebuyers who expect to move in a few years, taking out a 30-year fixed-rate mortgage involves paying (in the form of a higher interest rate) for protection against possible future rate increases, which is not needed. Furthermore, it is complicated for homeowners to figure out when to exercise their prepayment option. Because mortgages are priced to reflect average refinancing efficiency, more-educated households that can use the option to greater advantage are effectively cross-subsidized by less-efficient borrowers who pay more for the option than it is worth to them.

Such concerns suggest that there is an unresolved tension between the stated goals of continued federal support for 30-year mortgages and of moving to a mostly private and unsubsidized system. An alternative to accepting continued federal support for the 30-year mortgage as inevitable would be to use the transition to a new model as an opportunity to phase out federal subsidies for 30-year mortgages, and more generally to reconsider the types of mortgages that should be given the advantage of eligibility for federal backstop guarantees.



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